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Sylvester C. W. Eijffinger\*

## On a Reformed Stability and Growth Pact

*In March 2005, the Council of Economics and Finance Ministers (Ecofin) presented its own suggestions for a possible Stability and Growth Pact (SGP) reform in a Report to the European Council. The Council Report divides its proposals into three parts, namely improving governance, strengthening the preventive arm and improving the implementation of the Excessive Deficit Procedure (EDP). The present paper contains a critical analysis of the ideas contained in the Report, accompanied by comparisons of the suggestions with earlier proposals for reform in the literature and the Commission Communication of September 2004.*

Arguments for the reform of the Stability and Growth Pact (SGP) have been numerous ever since the first countries broke its rules, and some have even argued for its abolition. The discussion on whether the uniform rules of the Pact are still appropriate has been fuelled by the enlargement of the European Union by ten new Member States, leading to an EU that is considerably heterogeneous and economically diversified. In addition to the call for more flexibility, experience has shown that countries do not behave prudently in good times, which indicates that the Pact is asymmetric in nature, not giving the right incentives to fiscal policy-makers during economic upswings. The problems of the SGP with respect to enforcement and implementation reached their preliminary climax in November 2003 when the Council of Economics and Finance Ministers (Ecofin) suspended a Commission recommendation to start sanction procedures against Germany and France – a decision that was annulled by the European Court of Justice in July 2004. This Court ruling made a rethinking of the Pact's rationale, rules and implementation unavoidable. As a reaction to the SGP's problems in general and this Court ruling in particular, the European Commission published a Communication in September 2004 in which it presents proposals on how to enhance the effectiveness of the Pact's rules. In March 2005, the

Council of Ministers presented its own suggestions for a possible SGP reform in a report to the European Council.<sup>1</sup> This report underlines the willingness of the Council to keep the Pact alive and unchanged in its rules-based approach and its basis of the two nominal anchors of 3% of GDP for the deficit ratio and 60% for the debt ratio. According to the introduction to the Report, the proposals made aim at:

- strengthening and clarifying the implementation of the SGP;
- enhancing the economic underpinnings of the existing framework;
- better catering for differences between economic conditions in different Member States;
- keeping the rules as simple and transparent as possible.

Specifically, one of the declared goals of the suggestions that are presented in the Report is "not to increase the rigidity or flexibility of current rules but rather make them more effective".<sup>2</sup>

The present paper contains a critical analysis of the ideas contained in the Report, accompanied by comparisons of the suggestions with earlier proposals for reform in the literature and the Commission Communication of September 2004. It will be argued that the Report does address some fundamental issues, espe-

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<sup>1</sup> Annex II of the Presidency Conclusions, Brussels, 22 and 23 March 2005, hereafter referred to as "the Council Report (2005)".

<sup>2</sup> Council Report (2005), p. 2.

cially with regard to the correction of the pro-cyclical bias or the excessive uniformity of the rules. However, the proposals are insufficient to reform the SGP satisfactorily, but rather stay on the “soft side” avoiding addressing core issues such as partisan enforcement and sanctions.

The Council Report divides its proposals into three parts, namely improving governance, strengthening the preventive arm and improving the implementation of the Excessive Deficit Procedure (EDP). In the following, the Council suggestions put forward in each of these parts will first be briefly presented and then commented on.

### Improving Governance

The first area in which the Council sees room for improvement is governance.<sup>3</sup> Having affirmed that the respective institutions involved in the SGP should “deliver on their respective responsibilities”<sup>4</sup> and respect each other’s tasks, particularly the following points are mentioned to improve governance and national ownership:

- (1) effective and timely cooperation and communication between the institutions and the public and between the institutions themselves;
- (2) improved peer support and peer pressure based on a yearly assessment of national budgetary developments and their implications for the euro area as a whole;
- (3) complementary national budgetary rules and institutions to enhance national ownership;
- (4) a stability/convergence programme for the whole legislature when a new government has taken office, and furthermore a plea for continuity in that case with respect to the budgetary targets endorsed by the Council;
- (5) involvement of national parliaments in stability/convergence programmes;
- (6) reliable macroeconomic forecasts based on Commission forecasts;
- (7) enhanced quality, reliability and timeliness of fiscal statistics.

Improving governance surely is of certain relevance in reforming the SGP. The fact that the Council feels

compelled to mention that the respective institutions involved in the SGP have to respect each other’s tasks is revealing in this respect, but not surprising given that one of the SGP’s more recent problems actually was that one institution (the Council) largely neglected another’s (the Commission’s) role as “guardian of the Treaty and its procedures”<sup>5</sup> by not imposing the recommended sanctions on France and Germany despite their non-compliance with the rules of the SGP. But there is more to it: merely stating that Member States, the Commission and the Council have to respect each other’s responsibilities will not help to prevent a situation like the one of November 2003. Instead, as pointed out by Buti, Eijffinger and Franco<sup>6</sup> and Eijffinger<sup>7</sup>, in order to enhance non-partisan enforcement of the rules, the Commission would need more power in the decision on sanctions, e.g. by issuing proposals instead of recommendations to the Council. However, the Council Report clearly stresses that the institutions must deliver on their responsibilities *while avoiding any institutional shift*.<sup>8</sup> It remains to be seen whether the Council would interpret a strengthened role of the Commission in imposing sanctions as an institutional shift or as the respecting of its role as guardian of the Treaty and its procedures.

In spite of the undeniable importance of governance for the effectiveness of the SGP, the question remains to what extent the issues put forward in the report will actually improve it. In fact, these issues can be divided into three groups. The first group embraces point (1) and the general affirmation of institutions having to deliver their respective responsibilities – it is basically a re-confirmation of tasks and behavioural rules that should already have been clear anyway as inherent in the original Pact. As such, there is not much new to it and it is doubtful whether the mere statement of the need for improvement in these areas will really make a difference.

Points (2), (3), (4) and (5) constitute the second group – suggestions for which it is questionable whether improvements will really materialise. As Gros<sup>9</sup> states, peer support and peer pressure (2) for fiscal discipline, which according to the Council report is an “integral part of a reformed SGP”,<sup>10</sup> have so far proven

<sup>3</sup> Council Report (2005), pp. 4-7.

<sup>4</sup> Ibid., p. 4.

<sup>5</sup> Ibid.

<sup>6</sup> M. Buti, S. Eijffinger, D. Franco: Revisiting EMU’s Stability Pact: A Pragmatic Way Forward, in: Oxford Review of Economic Policy, Vol. 19, No. 1, 2003.

<sup>7</sup> S. Eijffinger: Reform of the Stability and Growth Pact: Evaluating the European Commission’s Communication of September 2004, Briefing Paper for the Monetary Dialogue of the European Parliament with the President of the ECB, November 2004.

<sup>8</sup> Council Report (2005), p. 4.

ineffective.<sup>11</sup> However, increased national ownership in the form of complementary budgetary rules and institutions (3) or more involvement of national parliaments in stability and convergence programmes (5) will not be a guarantee of improvement either in the light of the German experience. How much more can rules be nationally owned when they are already anchored in the Constitution of a country?<sup>12</sup> In the German case, this clearly did not help to ensure compliance with the rules even though the budget and deviations from it have to be presented to and discussed in Parliament. Finally, with respect to (4), the Council merely *invites* new governments to show continuity and provide for a stability programme for the whole legislature, which is in the end just a plea for yet another political commitment where neither compliance is rewarded nor non-compliance is punished. In sum, even if they are implemented as foreseen, one should be rather cautious to expect suggestions (2)-(5) to deliver substantial improvements in governance.

Finally, suggestions (6) and (7) denote useful ideas to improve the “SGP infrastructure”, that is, underlying conditions that are crucial for the functioning of the Pact. In accordance with Eijffinger,<sup>13</sup> the importance of reliable macroeconomic forecasts (6) to prevent a “hidden undermining of the SGP”<sup>14</sup> due to forecast errors is recognised. It can only be welcomed that the Council Report gives a prominent role to the independent Commission forecasts in Member States’ projections and the assessment of their macroeconomic and budgetary developments. Following the Commission Communication of 3 September 2004, emphasis is also put on the quality, reliability and timeliness of fiscal statistics (7), which is an issue that the Council and the Commission are to deal with in more detail in the course of 2005. Especially if the provision of unreliable low-quality data is subject to sanctions, this will certainly increase the transparency of budgetary positions and enhance financial markets’ ability to properly assess the creditworthiness of a Member State.

All in all however, the suggestions for improving governance, which is desirable as such, are not convincing and to a large extent not straightforward enough to

make much of a difference in practice. Except for the last two, they are guidelines and statements of intent heavily dependent on the good will of Member States rather than readily enforceable improvements.

### Strengthening the Preventive Arm

The second area that the Council Report on improving the working of the SGP deals with is a strengthened preventive arm,<sup>15</sup> that is, the (renewed) commitment of Member States to budgetary consolidation in periods of growth above trend in order to avoid pro-cyclical policies and an excessive debt or deficit level in bad times. Specifically, three points are put forward in this context.

- (1) Differentiation of the medium-term budgetary objective (MTO) across Member States taking into account differences in the economic and budgetary situation of the countries: the MTO (in cyclically adjusted terms, net of one-off and temporary measures) will be between -1% for low debt/high potential growth countries and balance or surplus for the high debt/low potential growth countries; implicit liabilities (especially those connected to the ageing of the population) should be taken into account as soon as criteria to deal with them appropriately are established and agreed upon.
- (2) Adjustment path to MTO: commitment to actively consolidate public finances in good times using unexpected extra revenues for deficit and debt reduction, the benchmark for adjustment to the MTO being 0.5% of GDP annually; in case of non-compliance, policy advice / early warnings (when the Draft Constitution is ratified) are to be issued by the Commission.
- (3) Structural reforms: major reforms with direct long-term cost-saving effects (especially pension reforms) are taken into account when assessing the adjustment path towards the MTO allowing for temporary deviations given that the 3% limit is respected and the budgetary position is expected to return to the MTO within the programme period.

Enhancing the commitment to fiscal discipline also in good times in order to tackle the asymmetric nature of the Pact has been demanded in the literature for a long time. Creating incentives to behave prudently in good times and thus correcting the pro-cyclical bias

<sup>9</sup> D. Gros: Reforming the Stability Pact, in: INTERECONOMICS, Vol. 40, No. 1, January/February 2005, pp.14-17.

<sup>10</sup> Council Report (2005), p. 5.

<sup>11</sup> D. Gros, op. cit., p.17.

<sup>12</sup> Article 110 (1) on Federal Budget and Budget Law of the German Basic Law states that: “... The budget shall be balanced with respect to revenues and expenditures.”

<sup>13</sup> S. Eijffinger, op. cit.

<sup>14</sup> S. Eijffinger, op. cit., p. 4.

<sup>15</sup> Council Report (2005), pp. 8-11.

by means of early warnings issued by the Commission has already been proposed by Buti, Eijffinger and Franco<sup>16</sup> and also reappeared in the Commission Communication of September 2004. In the light of this, the proposition on defining an adjustment path towards the MTO (2), which is – if necessary – accompanied by policy advice, is an overdue step in the right direction. Still, an annual adjustment of 0.5% of GDP is just a benchmark and it remains to be seen whether in practice some consistency will be noticeable on how much more than 0.5% should be corrected for in good times and how much less it may be when economic conditions are not that favourable, without letting full discretion in the strictness of its interpretation make this benchmark meaningless. Regarding the non-compliance with the prescribed adjustment path, a warning issued by the Commission is a more effective tool to create incentives to behave prudently than pure policy advice. However, for direct warnings to become feasible, one still needs to wait for the lengthy process of the ratification of the Draft Constitution. Consequently, this improved mechanism cannot be expected to become effective in the very near future.

The other two points put forward by the Council address what Buti, Eijffinger and Franco have identified as “excessive uniformity of the rules”.<sup>17</sup> Making the MTO dependent on the debt level, potential growth and eventually also implicit liabilities resulting from demographic changes (1) takes better account of country-specific differences in a European Union with increasingly heterogeneous Member States and rewards countries with relatively low debt levels and sustainable budgets, allowing them a less stringent MTO. In this point, the Council exactly follows the reasoning of the European Commission.<sup>18</sup> Point (3) again concerns the adjustment path towards the MTO, allowing for country-specific deviations when structural reforms with long-term cost-saving effects have been undertaken. In this way, it can be avoided that the implementation of urgently needed reforms is delayed or given up in order to be able to follow a too stringent adjustment path.

In sum, it is fair to say that the improvements suggested in the area of the “preventive arm” largely re-

spond to calls in the literature for more flexibility/less uniformity of the rules and for earlier actions to correct inadequate budgetary developments. Nevertheless, it might be questioned whether warnings and commitments to prudent behaviour in good times are effective given that they seem not to be working in bad times. Two points have to be mentioned in this respect (a third one will be stressed later on). On the one hand, good times provide more room for manoeuvre anyway as Member States face the “problem” of how to spend “unexpected extra revenue” for which no specific expenditure plan exists, whereas in times of economic difficulties, governments of Member States with an excessive deficit (ED) would have to reallocate money that is already foreseen for other projects to debt and deficit reduction, which is always more difficult. On the other hand, using unexpected extra revenue for deficit and debt reduction leads to lower debt levels, which in turn is rewarded with a relaxed MTO and more flexibility in government spending. As a result, the proposals put forward may indeed contribute substantially to correcting the pro-cyclical bias of the Pact.

#### Improving the Implementation of the EDP

Finally, the Council Report focuses on the clarification of, and possible improvements in, the implementation of the Excessive Deficit Procedure (EDP).<sup>19</sup> Issues dealt with include:

- (1) the preparation of a Commission report on the existence of an ED;
- (2) a widening of the definition of an “exceptional and temporary” ED over the reference value to cover all periods of negative growth and protracted periods of sluggish growth compared to potential growth;
- (3) the clarification of “all other relevant factors” taken into account when assessing the ED given it is temporary and close to the reference value, namely potential growth, prevailing cyclical conditions, policies to foster R&D and innovation, implementation of policies in the context of the Lisbon Agenda, fiscal consolidation efforts in good times, debt sustainability, public investment and the overall quality of public finances; special consideration is given to possible high levels of financial contributions to foster international solidarity and to achieving European policy goals (unification of Europe);
- (4) special attention to systemic pension reforms considering the net cost of the reforms for the initial five

<sup>16</sup> M. Buti, S. Eijffinger, D. Franco, *op. cit.*

<sup>17</sup> *Ibid.*

<sup>18</sup> European Commission: Communication from the Commission to the Council and the European Parliament: Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact, September 2004.

<sup>19</sup> Council Report (2005), pp. 11-18.

years after introduction when assessing whether the ED has been corrected;

- (5) the increasing focus on debt and sustainability through Council recommendations (issued in the framework of the Council opinion on the stability and convergence programmes) on debt dynamics for Member States above the reference values;
- (6) the extension of deadlines for the adoption of decisions and for taking effective action and measures in order for Member States to better frame actions on recommendations within the national budgetary procedure;
- (7) the extension of the initial deadline for correcting an ED from 1 to 2 years conditional on special circumstances identified, based on an overall assessment of "all other relevant factors" (see point (3));
- (8) the revision of deadlines for correcting the ED in case of unexpected adverse economic events with major unfavourable budgetary effects occurring during the EDP.

Whereas (1) just reconfirms the status quo stressing the Commission's responsibility to prepare a report identifying whether an excessive deficit exists and whether any exceptions apply that might make the launch of an EDP needless, the second group of issues – points (2)-(5) – focuses on exceptions giving Member States the possibility to escape an EDP in spite of deficits above the reference value. Points (6)-(8) finally deal with the correction of excessive deficits in the procedure, in particular with the deadlines prescribed in the Pact.

In both suggestions (2) and (5), the Council again closely follows proposals made by the European Commission<sup>20</sup> strengthening the economic reasoning of the Pact. Especially the increased focus on debt and sustainability is of particular importance in addressing the demographic problem, which is probably not stressed enough given that the implicit debt stock is already two to three times higher than the official debt stock in many EU Member States according to Hefeker.<sup>21</sup> Turning to points (3) and (4), even though any clarification of the term "all other relevant factors" is highly useful to limit the room for discretionary interpretation of when an exception might be justified and even though pension reforms may have a substantial

impact on future budgetary developments, the diversity of situations introduced that have to be taken into account when assessing a Member State's deficit is so broad that virtually every country with a temporary deficit close to but above the reference value can find a way to escape the EDP. This escape effectively raises the reference value to whatever is in practice considered close enough to the original 3% to make the exceptions apply. However, if the MTO and prudent behaviour in good times were taken seriously, these "EDP-escape options" would not be necessary as the 3% deficit limit or, even more strictly, the 1% MTO limit and the adjustment path towards it leave enough room to finance policies such as the ones mentioned under (3).

The envisaged extension of the various deadlines in the EDP is subject to considerations similar to those above. Introducing special circumstances under which the deadline for correcting an excessive deficit is extended – points (7) and (8) – opens the door to abuse of this clause by re-interpreting conditions as special with the consequence of providing a legal possibility to escape sanctions even when the excessive deficit is not corrected in time. Solely point (6), embracing *inter alia* the extension of the deadline (from 4 to 6 months) for the timing of taking effective action, is based on solid arguments. As the Council notes, extending this deadline allows Member States to better frame their action to correct an ED within the national budgetary procedure and to develop structural rather than temporal measures.<sup>22</sup>

In general, the Pact should be kept as simple and transparent as possible, thereby avoiding special provisions as much as possible. As Eijffinger states, simplicity should be given up "if and only if at the same time not only flexibility but also effectiveness through better enforcement of the Pact is enhanced".<sup>23</sup> In the case of the deadlines and the identification of an excessive deficit, the special circumstances that have to be taken into account seem to be designed to escape enforcement rather than to enhance it. In any case, introducing them does not improve fiscal discipline in Europe but unnecessarily complicates the Pact.

Interestingly, while mentioning every step in the EDP, including less important issues such as the reconfirmation of the Commission's role in preparing a report on the existence of an excessive deficit in a Member State, the Council Report devotes no attention at all

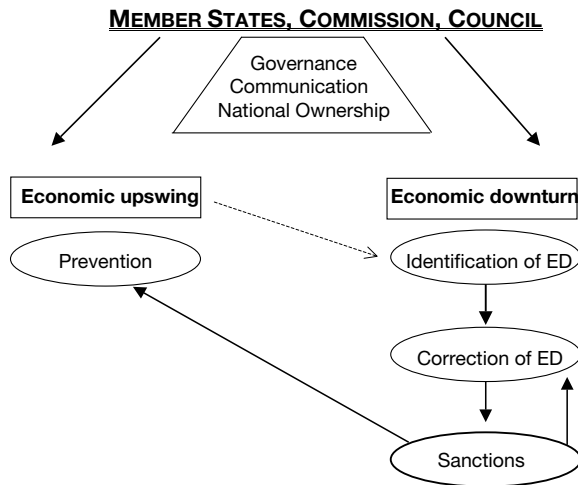
<sup>20</sup> European Commission, op. cit.

<sup>21</sup> C. Hefeker: Will a Revised Stability Pact Improve Fiscal Policy in Europe?, in: INTERECONOMICS, Vol. 40, No. 1, January/February 2005, pp.17-21.

<sup>22</sup> Council Report (2005), p. 16.

<sup>23</sup> S. Eijffinger, op. cit., p. 6.

**Figure 1**  
**The General Framework for Achieving Fiscal Discipline**



to the final step in the EDP – the imposition of sanctions if the ED is not corrected within the prescribed timeframe – despite the fact that the roots of much of the Pact’s recent trouble and as such most room for improvement lie in this area. Cynics may claim that the Council has simply recognised that sanctions *need not* to be dealt with, given that the special provisions introduced with all the possibilities to escape the EDP will make sure that no country ever gets into the situation of facing sanctions. Whatever the reasons for not mentioning sanctions might be, neglecting this crucial part of the SGP is a major flaw in the Council Report.

Figure 1 illustrates how sanctions fit into the general framework for achieving fiscal discipline. The institutions mentioned on top of the graph are responsible for the governance of the fiscal rules, for timely and complete communication and – in the case of Member States – for national ownership of the SGP rules. Good times should be used to consolidate budgets (→ prevention), which is dealt with in the Council Report under “strengthening the preventive arm”. In times where a Member State has problems complying with the fiscal rules, which will probably but not necessarily occur during an economic downturn, excessive deficits subject to the EDP should be identified (→ identification of ED) and corrected (→ correction of ED), otherwise sanctions are imposed (→ sanctions). Whereas the identification of an excessive deficit is done by the Commission, its correction is fully in the hands of Member States whose willingness to comply with the recommendations for adjustment crucially depends on

whether or not the threat of sanctions is credible and on the cost of these sanctions. When a country does not have to fear any (severe) punishment, it will not feel urged to correct its deficit in a timely manner – with or without extended deadlines. In other words, the right incentives will just be given in the presence of credible and costly sanctions. As the example of France shows, the problem stems not so much from the limited *ability* but primarily from the lack of *willingness* to correct the excessive deficit as fast as possible.

Additionally, Figure 1 highlights another reason why Member States would be willing to commit themselves to prudent policies in good times, a question already raised above. The threat of sanctions, if credible, will give an extra incentive to Member States to consolidate their budgets when possible (thus, in good times) in order to not get into an EDP in the first place. Therefore, credible and sufficiently high sanctions play a crucial role for both Member States’ commitment to adjust EDs and their willingness to behave prudently in good times. This implies that “improving the implementation of the SGP” (title of the Report) means to a large extent “improving the credibility of the threat of sanctions”. The proposition by Buti, Eijffinger and Franco<sup>24</sup> to base the decision of the Council on sanctions on a Commission *proposal* instead of a *recommendation* would be an important step in that direction as unanimity is required to move away from a proposal. Thus, less discretion is left in the hands of the Council, in which the same Ministers of Finance responsible for the national budgets and hence the excessive deficits have to decide on sanctions.

### General Evaluation

The Council Report on improving the implementation of the SGP addresses a variety of issues concerning the SGP. In its assessment, especially regarding the suggestions aimed at strengthening the preventive arm of the Pact proved to be useful. Other problems of the current SGP framework that are tackled concern the attempt to overcome the excessive uniformity of the rules by taking into account debt and sustainability in the definition of the MTO and the attempt to increase transparency by means of more reliable statistics and economic forecasts. Despite these useful elements, the Report contains a lot of suggestions that are either unlikely to really lead to improvements (see for example the ones aimed at improving governance) or that will even weaken or complicate the Pact without improving fiscal discipline (see e.g. the part on

<sup>24</sup> M. Buti, S. Eijffinger, D. Franco, op. cit.

improving the implementation of the EDP). Besides, comparing the actual proposals to the statement in the Introduction (see quote on page 1) reveals that some suggestions *do* increase the flexibility of the rules to a certain extent, that is in the new definition of the MTO depending on debt and sustainability levels, while the many possible exceptions for avoiding an EDP are effectively watering down the stringency of the 3% reference value. In this respect, the Council Report does not even keep up with its own declared objectives.

One of the main flaws of the Report is that it disregards the core issue of making the SGP rules more effective by (non-partisan) enforcement, especially regarding the imposition of sanctions. Member States' commitment to comply with the fiscal rules also in bad times can be ensured when non-compliance is rather probable and costly and thus undesirable. In this context, the reputational costs for a Member State of being in the EDP or having to pay fines are often put forward as a deterrent for a country to run into excessive deficits. These reputational costs could certainly play a role for countries that have never had an excessive deficit before. However, once a country is repeatedly breaching the rules, its reputational cost will diminish. Therefore, imposing sanctions on a Member State with a continuing excessive deficit is the only effective tool to give the right incentives towards fiscal discipline. In contrast, the proposals put forward by the Council Report seem to be characterised by an averseness to punishing any country. They largely rely on the hope that "national ownership" and "renewed commitments" will do the trick. "National ownership" seems to be the new trendy remedy for failed commitments, both with respect to the Lisbon Agenda and the SGP. Time will reveal whether the newly acquired prominent role of these terms in the European jargon is justified.

This leaves one question: why would "renewed commitments" to fiscal discipline work better than the original ones of a few years ago? If enforcement is not enhanced, they simply won't. The belief that the suggestions made in the Council Report will be a big step forward is thus heavily based on the assumption that over recent years governments have become a lot more credible in their "renewed commitments", even when facing virtually no negative consequences for breaking them. In this case, a simple and credible commitment to fiscal discipline in EMU would have been sufficient. This did not prove to be feasible under the present circumstances. Europe is waiting for renewed leadership within the large countries!